Journal of Accountancy

Volume 59 | Issue 2 Article 5

2-1935

Students' Department

H. P. Baumann

Students' Department

H. P. BAUMANN, *Editor*

AMERICAN INSTITUTE EXAMINATIONS

[NOTE.—The fact that these answers appear in THE JOURNAL OF ACCOUNTANCY should not cause the reader to assume that they are the official answers of the board of examiners. They represent merely the opinions of the editor of the *Students' Department.*]

EXAMINATION IN ACCOUNTING THEORY AND PRACTICE—PART I

November 15, 1934, 1.30 P. M. to 6.30 P. M.

Solve all problems.

No. 2 (20 points):

John Jones set up an irrevocable trust for the benefit of his eldest daughter, Joan Jones, to run until 1935, when she would be thirty years old and would receive the principal of the estate outright. If she should die before attaining the age of thirty, the trust would go to her younger sister, Ethel Jones. The net income of the trust could be withdrawn by the beneficiary at any time.

By the terms of the trust agreement John Jones was to be trustee during his life and was to receive a fee of $1,000 a year in lieu of commissions.

Any investments made for the trust were to be subject to the approval of the trustee only and not to be bound by any legal rulings regarding trust investments.

There was paid into the trust by gift from John Jones on January 1, 1921, the sum of $100,000 which was to be invested by the trustee.

On December 31, 1930, Joan died and bequeathed her entire estate to her brother Paul Jones to be held in trust for him. He was to receive the income and had the right of appointment of the principal. John Jones was made trustee and was to receive an annual fee of $1,000 instead of commissions.

The trial balance of John Jones, trustee, at December 31, 1930, was as follows:

Debits	
Cash—principal	$ 7,000
Cash—income	9,550
$300,000 par bonds 4% R. R. & I. due 1955 at cost, investment of principal	275,000
Stocks—2,000 shares of $100 each at cost, investment of undistributed income funds	150,000
Oil Venture Syndicate—investment of undistributed income funds	12,500
Accrued interest on bonds	950
Payments to beneficiary from income during 1930	2,500
Expenses applicable to income for year 1930	1,850
Expenses applicable to principal paid during 1930	1,000
Trustees' fees for year 1930	1,250
	$461,600
Credits	
Principal of trust—balance January 1, 1930	$275,000
Undistributed income balance January 1, 1930	138,500
Interest on bonds	12,800
Dividends	14,000
Profits on sale of principal investment bonds	9,200
Profits on stocks sold	9,600
Due trustee for fees	2,500
	$461,600

Analysis of undistributed income at January 1, 1930:

Interest received	$ 80,000
Dividends received	89,000
Profits on stocks sold	30,000
	$199,000
Expenses charged to income	$ 16,500
Fees to trustee	9,000
Payments to beneficiary	35,000
	$ 60,500
Balance December 31, 1930	$138,500

Analysis of principal at January 1, 1930:

January 1, 1921	$100,000
Increase to principal through sale of investments	190,000
Total	$290,000
Payment of expenses applicable to principal	15,000
Balance December 31, 1930	$275,000

During the three years ended December 31, 1933, the following transactions took place:

On December 31, 1931, the Oil Venture Syndicate was liquidated by receiving (a) 1000 shares no-par-value stock of the Oklahoma Oil Producers, Incorporated, of which the market value at December 31, 1931, was $10 a share; (b) $6,250 in cash; and (c) $12,500 5% Stanton Oils of California bonds due in 1955 of which the market value at December 31, 1931, was 80.

During the year 1932 the trustee sold $150,000 par value of the 4% R. R. & I. bonds at a net profit of $25,000 and invested the money in U. S. government 3¾% bonds at 100 net.

During 1932 the trustee invested $10,000 of undistributed income funds of the Paul Jones trust in Standard Oil of New Jersey at $40 per share, receiving 250 shares; the expense of the purchase amounted to $50.

On January 25, 1933, the trustee sold $12,500 par value bonds of Stanton Oils of California for $12,500 net and invested the proceeds in Tulsa city 4% bonds at 100 net.

During the three years ended December 31, 1933, there was collected:

Interest on R. R. & I. bonds	$26,321.25
Interest on Stanton Oils of California	625.00
Interest on U. S. government bonds	10,053.75
Interest on Tulsa city bonds	500.00
Dividends on stocks	40,000.00

During the same three years there was disbursed:

Payments to Ethel Jones as beneficiary	$ 6,000.00
Payments to Paul Jones as beneficiary	10,000.00
Expenses paid chargeable to income of the principal trust	4,000.00
Expenses paid chargeable to income of the undistributed income trust	3,500.00
Fees paid trustee	3,000.00
The account payable to trustee at Jan. 1, 1931, was liquidated	

No legal accounting was filed by the trustee during the whole period of the trusts.

Prepare statements from which the trustee may file this legal accounting. Disregard all taxes.

Solution:

Exhibits A to D are presented in the form in which they might be filed by the trustee as his legal accounting. The working papers which follow are submitted to show the derivation of the items appearing in the exhibits, and are not intended to be part of the legal accounting.

JOAN AND ETHEL JONES TRUST — *Exhibit A*

JOHN JONES, TRUSTEE

Report as to principal, January 1, 1921, to December 31, 1933

I charge myself with:		
Assets placed in trust, January 1, 1921	$100,000	
Profit on sale of principal investments	224,200	
Total charges		$324,200
I credit myself with:		
Payment of expenses chargeable to principal		16,250
Balance as to principal		$307,950
Consisting of:		
Cash	$ 7,950	
Bonds 4%—R. R. & I.; par $150,000; cost	137,500	
U. S. Government 3¼% bonds	162,500	
Total	$307,950	

JOAN AND ETHEL JONES TRUST — *Exhibit B*

JOHN JONES, TRUSTEE

Report as to income, January 1, 1921, to December 31, 1933

	January 1, 1921, to December 31, 1930	January 1, 1931, to December 31, 1933	Total
I charge myself with:			
Interest received	$ 92,800	$ 35,425	$128,225
Dividends received	103,000		103,000
Profits on stocks sold	39,600		39,600
Total charges	$235,400	$ 35,425	$270,825
I credit myself with:			
Expenses chargeable to income	$ 18,350	$ 4,000	$ 22,350
Fees to trustee	10,000	3,000	13,000
Payments to beneficiary			43,500
Joan Jones	37,500		
Ethel Jones		6,000	
Total credits	$ 65,850	$ 13,000	$ 78,850
Undistributed income for the period	$169,550	$ 22,425	$191,975

Net assets turned over December 31, 1930, to John Jones as trustee for the estate of Joan Jones:				
Cash	$ 9,550			
Stocks—2,000 shares	150,000			
Oil venture syndicate	12,500			
Total	$172,050			
Less: accrued trustee's fees	2,500			
Net assets		$ 169,550		$ 169,550
Balance as to income			$ 22,425	$ 22,425
Consisting of:				
Cash	$ 25,425			
Less: accrued trustee's fees	3,000			
Net assets	$ 22,425			

ESTATE OF JOAN JONES *Exhibit C*

JOHN JONES, TRUSTEE

Report as to principal, December 31, 1930, to December 31, 1933

I charge myself with:		
Inventory of assets, December 31, 1930:		
Cash	$ 9,550	
Stocks	150,000	
Oil venture syndicate	12,500	$172,050
Syndicate profit		13,750
Profit on sale of bonds		2,500
Total charges		$188,300
I credit myself with:		
Liability paid—trustee's fees accrued December 31, 1930		2,500
Balance as to principal		$185,800
Consisting of:		
Cash	$ 13,300	
Stocks—2,000 shares	150,000	
Stock of Oklahoma Oil Producers, Inc.	10,000	
Tulsa City 4% bonds	12,500	
Total	$185,800	

ESTATE OF JOAN JONES — *Exhibit D*

JOHN JONES, TRUSTEE

Report as to income, December 31, 1930, to December 31, 1933

I charge myself with:		
Dividends received	$ 40,000	
Interest received	1,125	
Total charges		$ 41,125
I credit myself with:		
Expenses chargeable to income	$ 3,500	
Trustee's fees	3,000	
Payments to beneficiary—Paul Jones	10,000	
Total credits		16,500
Balance as to income		$ 24,625
Consisting of:		
Cash	$ 14,575	
Standard Oil of New Jersey stock	10,050	
Total	$ 24,625	

The foregoing exhibits were prepared directly from the working papers, except for certain items in exhibit A and the first column of exhibit B, the computation of which follows:

Working papers for exhibit A

	Profit on sale of investments	Expenses
January 1, 1921, to January 1, 1930—from problem	$190,000	$ 15,000
Year 1930—working papers, column 2	9,200	1,250
1931 through 1933—working papers, column 5	25,000	
Totals, to exhibit A	$224,200	$ 16,250

Working papers for exhibit B

	January 1, 1921, to January 1, 1930 (per problem)	Year 1930 (Working papers, column 6)	January 1, 1921 to December 31, 1930 (to exhibit B)
Interest received	$ 80,000	$12,800	$ 92,800
Dividends received	89,000	14,000	103,000
Profits on stocks sold	30,000	9,600	39,600
Total	$199,000	$36,400	$235,400

Expenses charged to income..	$ 16,500	$ 1,850	$ 18,350
Fees to trustee............	9,000	1,000	10,000
Payments to beneficiary.....	35,000	2,500	37,500
Total................	$ 60,500	$ 5,350	$ 65,850
Undistributed income balance	$138,500	$31,050	$169,550

Explanation of working papers

The trial balance of the Joan Jones trust as of December 31, 1930, was entered in column (1). Accounts pertaining to the principal of this trust were extended to columns (2) and (3), in order to obtain in column (3) the December 31, 1930, trial balance of the Ethel Jones trust. Accounts pertaining to the undistributed income of the Joan Jones trust were extended to columns (6) and (7), in order to obtain in column (7) the December 31, 1930, trial balance of the Estate of Joan Jones.

The transactions for the three-year period were entered in columns (4) and (8), and applied to the balances in columns (3) and (7), respectively, to determine the trial balances as of December 31, 1933, which appear in columns (5) and (9).

THE JONES TRUSTS

JOHN JONES, TRUSTEE

Working papers—December 31, 1930, to December 31, 1933

	Joan Jones trust	Ethel Jones trust				Estate of Ethel Jones, in trust for Paul Jones			
	Trial balance Dec. 31, 1930	Principal Dec. 31, 1930	Trial balance Dec. 31, 1930	Transactions 1931 thru 1933	Trial balance Dec. 31, 1933	Principal Dec. 31, 1930	Trial balance Dec. 31, 1930	Transactions 1931 thru 1933	Trial balance Dec. 31, 1933
Debits	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Cash—principal	$ 7,000		$ 7,000	$162,500 (2)	$ 7,950		$ 9,550*	$ 6,250 (1)	$ 13,300
				162,500* (3)				2,500* (8)	
				950 (7)					
Cash—income	9,550			35,425 (7)	25,425			10,050* (4)	14,575
				10,000* (8)				12,500 (5)	
								12,500* (6)	
								41,125 (7)	
								16,500* (8)	
Bonds—R. R. & I.	275,000		275,000	137,500* (2)	137,500				
Stocks	150,000						150,000		150,000
Oil venture syndicate	12,500						12,500	12,500* (1)	
Accrued interest on bonds	950		950	950* (7)					
Payments to beneficiary from income	2,500					$ 2,500*			
Expenses applicable to income	1,850					1,850*			
Expenses applicable to principal	1,250	1,250*							
Trustee's fees	1,000					1,000*			
	$461,600		$282,950				$172,050		
Stock of Oklahoma Oil Producers, Inc.								10,000 (1)	10,000
Stanton oils bonds								10,000* (5)	
								10,000 (1)	

U. S. Government 3¼% bonds				$162,500	(3)	$162,500					
Standard Oil of New Jersey stocks									$10,050	(4)	$10,050
Tulsa City 4% bonds									12,500	(6)	12,500
Payments to beneficiary				6,000	(8)	6,000			10,000	(8)	10,000
Expense chargeable to income				4,000	(8)	4,000			3,500	(8)	3,500
Trustee's fees				3,000	(9)	3,000			3,000	(8)	3,000
				$63,425		$346,375			$54,875		$226,925
Credits											
Principal of trust, Jan. 1, 1930	$275,000	$275,000									
Undistributed income, Jan. 1, 1930	138,500						$138,500				
Interest on bonds	12,800						12,800				
Dividends	14,000						14,000		40,000	(7)	$40,000
Profits on sale of principal bonds	9,200	9,200		25,000	(2)	25,000			2,500	(5)	2,500
Profits on stocks sold	9,600						9,600				
Due trustee for fees	2,500							$ 2,500	2,500*	(8)	
	$461,600										
Principal of Joan Jones trust, Dec. 31, 1930, which became the Ethel Jones trust		$282,950	$282,950			282,950					
Undistributed income of Joan Jones trust, Dec. 31, 1930, which became the estate of Joan Jones, in trust for Paul Jones							$169,550	169,550			169,550
								$172,050			
Syndicate profit									13,750	(1)	13,750
Bond interest				35,425	(7)	35,425			1,125	(7)	1,125
Due trustee for fees				3,000	(9)	3,000					
				$ 63,425		$346,375			$ 54,875		$226,925

* Deduction. a Note extension to "Cash—principal" line; this becomes principal cash of the Paul Jones trust.

Transactions and entries therefor

(1)	Stock of Oklahoma Oil Producers, Inc.	$ 10,000	
	Stanton Oils bonds	10,000	
	Cash—principal	6,250	
	Oil venture syndicate		$12,500
	Profit on syndicate		13,750
	To set up (at market value) assets received by estate in liquidation of syndicate.		
(2)	Cash—principal	162,500	
	Bonds, R. R. & I.		137,500
	Profit on sale of principal bonds		25,000
	To record sale of $150,000 par value (one-half of total) of R. R. & I. bonds at $25,000 profit.		
(3)	U. S. Government 3¾% bonds	162,500	
	Cash—principal		162,500
	To record investment of proceeds of above sale.		
(4)	Standard Oil of New Jersey stock	10,050	
	Cash—income		10,050
	To record purchase by Estate.		
(5)	Cash—principal	12,500	
	Stanton Oils bonds		10,000
	Profit on sale of principal bonds		2,500
	To record sale of bonds for $12,500.		
(6)	Tulsa City 4% bonds	12,500	
	Cash—principal		12,500
	To record investment of proceeds of above sale.		
(7)	Cash—principal (bond interest accrued December 31, 1930)	950	
	Cash—income	35,425	
	Accrued interest on bonds		950
	Bond interest		35,425
	To record income of Ethel Jones trust.		
	Cash—income	41,125	
	Bond interest		1,125
	Dividends		40,000
	To record income of Estate.		
(8)	Payments to beneficiary	6,000	
	Expenses chargeable to income	4,000	
	Cash		10,000
	To record disbursements of Ethel Jones trust.		
	Payments to beneficiary	10,000	
	Expenses chargeable to income	3,500	
	Trustee's fees	3,000	
	Due trustee for fees	2,500	
	Cash—principal		2,500
	Cash—income		16,500
	To record disbursements of Estate.		

(9) Trustee's fees	$3,000	
Due trustees for fees		$3,000

To accrue fees payable to John Jones as trustee of the Ethel Jones trust. (After December 31, 1930, Jones is entitled to an annual commission of $1,000 from each of the trusts, or a total compensation of $6,000 for the period; he was paid only $3,000. Entry (8) assumes that this payment was made by the Estate, and accordingly the accrual is made by the Ethel Jones trust).

No. 3 (20 points):

The "A" Telephone Company was incorporated on January 1, 1931, for the purpose of acquiring and holding securities of companies operating telephone systems. The authorized capital stock consisted of 2,500 shares of $6 cumulative preferred stock without par value and 3,000 shares of common stock without par value. The authorized funded debt was $500,000. On January 1, 1934, three years later, the company voluntarily filed a petition in bankruptcy. An attorney for the bondholders' committee has asked you to examine the accounts and records of the company to determine why it was necessary to file such a petition when it had a surplus of $361,500 as shown by the following analysis of the company's surplus account:

Analysis of surplus account
January 1, 1931, to December 31, 1933

Date				Debit	Credit
1- 1-31	Excess of consideration paid in by shareholders, for shares having no par value, over the amount allotted to stated capital, as follows:				$285,000
	Cash paid in by shareholders....		$500,000		
	Capital stock issue:				
	2,000 shares $6 dividend, no par, preferred stock, stated value $100 per share.......	$200,000			
	3,000 shares no par, common stock, stated value $5 per share.......	$15,000	$215,000		
	Excess consideration paid in....		$285,000		
1- 1-31	Discount on purchase of 5,000 shares (total authorized) "B" Telephone Company common stock, par value $100 per share. The company entered this stock in its investment account at par, $500,000.......				$ 10,000
7- 1-31	Discount on sale of $500,000 par value "A" Telephone Company 6% ten year debenture bonds, dated 7-1-31...............			$50,000	
12-31-31	Net profit from operations for the year ended December 31, 1931, (includes $50,000 undistributed profit for the same year, of the "B" company which was taken into earnings by charging that company's current account)...........................				20,000

12–31–31	Dividends declared on preferred stock for the year ended December 31, 1931..........	$12,000	
12–31–31	Dividends waived by shareholders owning 500 shares of preferred stock...........		$3,000
1– 1–32	Discount on purchase of $400,000 par value "C" Telephone Company 5%, twenty year, sinking fund gold bonds, dated January 1, 1922..............................		20,000
6–30–32	Unrealized profit from the exchange of "B" Telephone Company's common stock for 6,000 shares (total authorized) "C" Telephone Company common stock without par value. The latter stock was taken into the investment account at the stated value thereof, namely, $600,000.............		100,000
6–30–32	Discount on sale of 500 shares of "A" Telephone Company $6 cumulative preferred stock, stated value $100 per share.......	5,000	
12–31–32	Net profit from operations for the year ended December 31, 1932, (includes $20,000 undistributed profit for the six months ended December 31, 1932, of the "C" Telephone Company which was taken into earnings by charging that company's current account)...........................		10,000
12–31–32	Dividends declared on preferred stock for the year ended December 31, 1932..........	13,500	
1– 1–33	Discount on purchase of 600 shares of the company's preferred stock. This stock was cancelled.......................		9,000
12–31–33	Net loss from operations for the year ended December 31, 1933....................	15,000	
		$95,500	$457,000
			95,500
	Balance December 31, 1933..............		$361,500

The articles of incorporation authorize the directors to purchase preferred capital stock which is to be retired from earned surplus.

At the date of filing the petition in bankruptcy, the total investments owned by the company consisted of the 6,000 shares of "C" Telephone Company's common stock and $5,000 par value, United States Treasury bonds. The latter bonds were purchased at par. The "C" Telephone Company went into the hands of a receiver on July 31, 1933.

From the foregoing data prepare an adjusted analysis of surplus account. Comment briefly upon any additional facts which you feel will be of value to your client.

Solution:

Note 1. The discount of $10,000 on the purchase of the 5,000 shares (total authorized) of the common stock of the "B" Telephone Company should be eliminated from the accounts. The actual cost of this stock purchase, $490,000 should have been charged to the investment account, and no entry should have been made for the discount. On June 30, 1932, when this stock was exchanged for the total authorized capital stock of the "C" Telephone Company, a credit of $100,000 was entered into the surplus account. This credit should also be eliminated. Later, on July 31, 1933, the "C" Telephone Company went into the hands of a receiver As no estimate of the probable recovery, if any, is given in the problem, the entire cost of $490,000 should be reserved against by a charge to surplus.

Note 2. The discount on sale of $500,000 par value "A" Telephone Company, 6 per cent. ten-year debenture bonds, dated July 1, 1931, should be amortized over the life of the bonds. In this solution, the straightline method of amortization is used, with the result that charges are made against income as follows:

Six months	1931	$2,500
Year	1932	5,000
Year	1933	5,000

The unamortized balance should appear as a deferred charge in the balance-sheet.

Note 3. On December 31, 1931, and again on December 31, 1932, the company took up into its surplus account, the book profits of its subsidiary, ("B" Telephone Company, and later, "C" Telephone Company) by a debit to the current accounts. These profits were unrealized and should not have been considered as profits. The actual operating losses of "A" Telephone Company, which were netted against the book profits of the subsidiary, should be increased by the amount of bond discount amortization (note 2).

Note 4. The dividend waived by the shareholders owning 500 shares of preferred stock is treated as a donated surplus. The effect of the waiver is the same as a payment to these stockholders of the amount of their dividend, and a donation by them to the corporation of a like amount.

Note 5. The statutes of the state will govern the treatment of the $9,000 discount on the 600 shares of the preferred stock which were purchased and cancelled. It should be noted that the problem does not state the amount received on these shares when they were originally issued.

Note 6. The directors acted contrary to the articles of incorporation which provided that the preferred stock "is to be retired from earned surplus" when they purchased the 600 shares of the company's stock on January 1, 1933. At that date, the company had no earned surplus. Whether the directors had the right to declare dividends on the preferred stock depends upon the statutes of the state of incorporation.

Note 7. The problem states that "At the date of filing the petition in bankruptcy, the total investments owned by the company consisted of the 6,000 shares of 'C' Telephone Company's common stock and $5,000 par value, United States treasury bonds." Hence, it must be concluded that the "C" Telephone Company 5 per cent. sinking fund-gold bonds which were purchased on January 1, 1932, at a discount of $20,000 were disposed of between the date of purchase and the date of the filing of the petition in bankruptcy. The manner of disposal, and the amount received, are not given in the problem. Since there are no entries in surplus for premium or discount on the sale of the bonds, it is assumed that these bonds were sold at par and that a profit of $20,000 was realized.

Note 8. The discount on the preferred stock purchased and retired is shown as a separate item in surplus, because according to the statutes of most states which refer to "stated capital," the term denotes that portion of the consideration received for the sale of stock which has been set aside as the permanent capital of the corporation, and which may be reduced only by statutory action.

Cancellation of preferred shares purchased for retirement, when reported to and approved by the state authorities, reduced the stated capital, the reduction in stated capital being equal to the cost of the stock retired, but not to exceed the stated value thereof. Accordingly, under this interpretation, the discount on the stock retired still remains part of the stated capital of the corporation.

The "discount" (from stated value) on the preferred stock sold June 30, 1932, should probably be deducted from the stated value of the capital stock in the balance-sheet, and should not appear in the surplus statement. On the basis of the above-stated statutory conception of stated capital, it does not seem legally possible to issue stated value stock at a discount; if it is permitted by statute, the discount should preferably be deducted from the capital stock to show the actual amount paid in for the stock.

Since the concept of stated capital is wholly statutory, the treatment of these two items would be governed entirely by the statutes applicable.

THE "A" TELEPHONE COMPANY

Analysis of surplus account

For the period from January 1, 1931, to December 31, 1933

Deficit:			
December 31, 1931:			
Net loss for the year (note 3).........	$32,500		
Dividend on preferred stock (note 6)...	12,000	$ 44,500	
December 31, 1932:			
Profit on sale of "C" Telephone Company bonds (note 7)...............	*$20,000*		
Net loss for the year (note 3).........	15,000		
Dividend on preferred stock (note 6)...	13,500	8,500	
December 31, 1933:			
Net loss for the year.................	$20,000		
Provision for loss on the investment in the stock of "C" Telephone Company (note 1).........................	490,000	510,000	
Total deficit...................			$563,000
Paid-in surplus:			
January 1, 1931:			
Excess of consideration paid in by shareholders, for shares having no par value, over the amount allotted to stated capital....................		$285,000	
Donated surplus:			
December 31, 1931:			
Dividends waived by shareholders owning 500 shares of preferred stock (note 4).........................		3,000	
Discount on preferred stock retired:			
Discount on 600 shares purchased January 1, 1933, and cancelled (note 8)........		9,000	297,000
Net deficit, December 31, 1933............			$266,000